In addition, the 1981 act established 10-year amortization of construction-period property tax and interest expenses for developers of all rental housing and provided a 25 percent investment tax credit for rehabilitation expenses for income-producing residential and nonresidential property certified as historic. All these changes taken together--especially the ACRS--appear to have lessened the relative attractiveness of owner-occupied housing as an investment, compared to other assets such as business plant and equipment and rental housing.

The Tax Equity and Fiscal Responsibility Act of 1982 also shifted the balance of investment incentives. The 1982 act repealed some accelerated cost recovery provisions for assets other than real property that were to have taken effect in 1985 and 1986. In addition, the 1982 act reduced the net value of the tax credit for the rehabilitation of income-producing properties certified as historic--a provision that principally benefits investors in housing. The depreciable value of these properties now must be reduced by 50 percent of the value of this tax credit before cost recovery can begin.

Other provisions of the 1982 tax act modified the tax-exempt mortgage revenue bond program in several ways. The permissible spread between the effective mortgage interest rate and the interest rate on the bonds was increased from 1.0 to 1.125 percentage points, and the proportion of bond-financed mortgages that could go to other than first-time homebuyers was increased slightly. Also, the maximum purchase price limits were raised from 90 percent to 110 percent of the average in non-targeted areas and from 110 percent to 120 percent of the average in targeted areas. In addition, the 1982 act gave state and local housing finance agencies the authority to issue tax-exempt mortgage revenue bonds to finance cooperative unit share loans. 15/

Finally, the 1982 tax act reduced the excess bad debt reserve tax deduction available to thrift institutions. It lowered from 40 percent to 34 percent the maximum proportion of total taxable income that they may treat as an addition to their bad debt reserves if they hold certain minimum shares of their assets in qualifying forms.

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15. Cooperative unit share loans are loans made to purchasers of individual cooperative units to finance a proportionate share of total project costs.

RESULTING CHANGES IN THE MORTGAGE MARKET

Shifts in credit markets and in federal policies have altered the major institutional sources and the forms of mortgages, as well as the cost of housing credit.

Changes in the Sources of Mortgage Credit

Over the past few years, both the sources of mortgage loan originations and, especially, the disposition of the loans after they are written have changed. Although savings and loan associations continue to originate more long-term mortgages on one- to four-unit homes than any other single source, their share of the total has declined in recent years, reaching approximately 37 percent in 1982--the lowest level since 1970 (see Table 3). More striking has been the change in the placement of mortgages after origination. Before this recent period of inflation and high interest rates, savings and loan associations retained in their portfolios most of the mortgage loans they originated. Recent housing market circumstances, however, have prompted them either to sell most of their newly originated mortgages to the federally sponsored credit agencies or to pool them to back securities.

Because savings and loan associations now retain fewer of their newly originated mortgages, they contribute less of the net addition to outstanding mortgage debt. Between 1978 and 1982, the share of net additions to outstanding mortgage debt accounted for by savings and loan associations declined from 40 percent to -8 percent. 16/ During that same period, the share of all outstanding mortgage debt held by the savings and loan associations declined much less--from 46 percent to 38 percent--reflecting their large accumulated mortgage holdings. The net addition by households to outstanding mortgage debt increased from 10 percent to 24 percent between 1978 and 1982, reflecting the need of households to help provide financing (often through second mortgages) in order to sell their units when interest rates are high.

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16. The negative percentage reflects the fact that the total outstanding mortgage debt held by savings and loan associations at the end of 1982 was less than the total held at the end of 1981. Data on mortgage debt holdings by the depository institutions do not include the MBSs held in their portfolios, because these data are not available separately. If MBSs were counted as part of the outstanding mortgage debt held by the depository institutions, their reported shares of the net additions to outstanding mortgage debt would rise and the reported share of the net additions held in mortgage pools would decline.

TABLE 3. PERCENTAGE SHARE OF MORTGAGE LOAN ORIGINATIONS, NET ADDITIONS TO OUTSTANDING MORTGAGE DEBT, AND OUTSTANDING MORTGAGE DEBT HELD BY SELECTED CREDIT SOURCES, 1978-1982 a/

Sources	1978	1979	1980	1981	1982 b/
Savings and Loan Associations					
Originations of Mortgage Loans c/	48.6	44.4	45.7	42.8	36.7
Net Additions to Outstanding Mortgage Debt	40.2	32.3	26.8	17.6	-8.0
Outstanding Mortgage Debt	46.2	44.3	42.5	40.7	37.8
Federally Sponsored Credit Agencies d/					
Net Additions to Outstanding Mortgage Debt	8.0	7.7	8.0	6.0	12.2
Outstanding Mortgage Debt	5.3	5.6	5.8	5.9	6.4
Mortgage Pools e/					
Net Additions to Outstanding Mortgage Debt	11.0	18.3	19.5	18.5	38.3
Outstanding Mortgage Debt	8.5	9.9	10.9	11.4	13.5
Households					
Net Additions to Outstanding Mortgage Debt	10.2	13.5	21.4	26.9	24.1
Outstanding Mortgage Debt	8.5	9.2	10.4	11.5	12.4

SOURCES: Data from the U.S. Department of Housing and Urban Development and the Federal Reserve System.

NOTE: Since these figures are from selected sources, the percentages do not add to 100.

TABLE 3. (Continued)

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a. For additional detail, see Appendix tables D-5, D-6, and D-7.

b. Data on mortgage originations are for the entire year 1982. Data on outstanding mortgage debt are from the third quarter of 1982. Data on net additions to outstanding mortgage debt are from the second quarter of 1982.

c. Originations are of long-term residential mortgage loans on one- to four-unit houses. Originations data are not available for mortgage pools because these do not originate mortgages. Originations data are not available separately for households.

d. Includes the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Federal Land Banks, the Federal Intermediate Credit Banks, and the Banks for Cooperatives.

e. The category "mortgage pools" is comprised not of institutions or individuals but of mortgages--mainly federally insured or guaranteed--grouped together to back securities issued and/or guaranteed for trading in the secondary market. Although the securities are held primarily by institutions, because of the large proportion of securities held by nominees on behalf of investors, it is not possible to apportion the pools accurately by investor institutions. For that reason, mortgage pools are treated separately from other mortgage investments.

These changes in the net additions to mortgage debt and in total mortgage debt outstanding have been made possible largely by greater use of federally sponsored credit agencies and mortgage pools by primary mortgage lenders. Between 1978 and 1982, net additions to outstanding mortgage debt accounted for by federally sponsored credit agencies--the FNMA and the FHLMC--rose from 8 percent to 12 percent of the total, while their share of total mortgage debt outstanding grew from 5 percent to 6 percent. Over the same period, net additions to mortgage debt accounted for by mortgage pools--that is, mortgages grouped together to back securities--increased from 11 percent to 38 percent of the total, and outstanding mortgage debt in pools as a share of all outstanding mortgage debt rose from 9 percent to 14 percent.

Recent increases in the shares of mortgage debt held by federal secondary market credit entities or placed in pools to back securities reflect the steady rise in federally supported secondary market activity since the beginning of the last decade. Between 1970 and 1982, mortgages in pools backing federally underwritten MBSs rose from 0.1 percent to 15.1 percent of all residential mortgage debt outstanding (see Table 4). During the same period, the volume of outstanding federally underwritten MBSs increased from less than $1 billion to $189 billion. The volume of outstanding GNMA MBSs rose fairly steadily over those years from $0.4 billion in 1970 to $119 billion in 1982. The volume of FHLMC MBSs outstanding rose much more slowly during the 1970s but jumped to $56 billion in 1982. FNMA MBSs first appeared in 1981, and by the end of 1982 nearly $15 billion of them were outstanding. The majority of the increase between 1981 and 1982 can be attributed to the swap programs operated by both the FNMA and the FHLMC.

Although complete data on private-sector MBS activity are not available, private activity has been slower to develop than federally sponsored activity. The first major issues of private conventional MBSs--by the Bank of America and the First Federal Savings and Loan Association of Chicago--did not take place until 1977. These publicly placed issues--that is, issues sold on the market through competitive bidding--were followed by very few additional private issues between that year and 1981. In fact, only $1.6 billion in MBSs was publicly placed by private issuers over that period. 17/ Although private issuers can also privately place the MBSs they issue--that is, sell the securities outside the market bidding process--only an additional $2.2 to $2.8 billion in MBSs was privately placed as of June 30, 1982, according to available data. 18/

Changes in the Forms of Mortgage Credit

The forms of mortgage credit instruments have changed substantially in the last five years.

Although depository institutions now offer several different instruments to better match the rates on their short-term deposit account liabilities and their long-term mortgage assets, comprehensive data on the use of various forms of mortgage credit are not available. Data from a FHLBB sample

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17. The Federal Home Loan Mortgage Corporation, The Secondary Market in Residential Mortgages, Publication No. 67, revised June 1982, p. 30.

18. Lepercq, de Neuflize and Co., Summary of Mortgage-Backed Securities Issued (outstanding as of June 30, 1982).

TABLE 4. OUTSTANDING FEDERALLY UNDERWRITTEN MORTGAGE-BACKED SECURITIES, 1970-1982 a/

End of Period	Securities Outstanding (Billions of Dollars) Issued and/or Guaranteed By GNMA	FHLMC	FNMA	Total	Total as Percent of Outstanding Residential Mortgage Debt
1970	0.4	---	---	0.4	0.1
1971	3.1	0.1	---	3.2	0.8
1972	5.5	0.4	---	5.9	1.3
1973	7.9	0.8	---	8.7	1.7
1974	11.8	0.8	---	12.6	2.3
1975	18.3	1.6	---	19.9	3.4
1976	30.6	2.7	---	33.3	5.1
1977	44.9	6.6	---	51.5	6.7
1978	54.4	11.9	---	66.3	7.5
1979	76.4	15.2	---	91.6	9.1
1980	93.9	16.9	---	110.8	10.0
1981	105.8	19.8	0.7	126.3	10.9
1982	119.2	55.7 b/	14.5 b/	189.4	15.1

SOURCE: Data from the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and the Board of Governors of the Federal Reserve System.

a. Includes both securities backed by loans on one- to four-unit homes and securities backed by mortgages on multifamily properties. In 1982, one- to four-unit loans backed 97 percent of the securities guaranteed by the GNMA, 84 percent of the securities issued by the FHLMC, and 100 percent of the securities issued by the FNMA. Data on the share of mortgages backed by single-family loans are not available for the GNMA and the FHLMC prior to 1974. Table excludes securities issued by the Farmers Home Administration. Those securities take the form of borrowing from the Treasury and are used to finance direct subsidized loans for low- and moderate-income housing.

b. Includes mortgage-backed securities traded under the swap programs of the FNMA and the FHLMC.

survey of lending activity compiled monthly since January 1981 are illustrative of the trend, however. 19/ Between January 1981 and January 1983, alternative mortgage instruments increased from 1 percent to an estimated 36 percent of all newly originated loans.

Once issued, these alternative mortgages are generally intended for sale to the FNMA, to the FHLMC, or directly to private investors or financial institutions to increase the supply of funds for additional loans. The FNMA, in particular, has become a major purchaser of adjustable rate mortgages, as reflected by the increased volume of their purchases from $107 million during 1981 to $3.2 billion in 1982. Both the FNMA and the FHLMC have also contributed to the development of alternative mortgage instruments through their willingness to purchase a variety of different kinds of adjustable rate loans.

Changes in the Cost of Mortgage Credit

Finally, the nominal and inflation-adjusted costs of mortgage credit have changed appreciably in the past decade, along with general economic conditions. Changes in federal policy during the last few years alone may also alter the cost of mortgage credit in the future relative to other forms of borrowing.

Although the sharp rise in inflation during the 1970s and early 1980s was reflected in rises in nominal interest rates, the same increase in inflation--and the relative isolation of mortgage lending institutions from the full effect of interest-rate fluctuations in the cost of their funds--often resulted in low, or even negative, interest costs net of inflation for homebuyers. In 1970, for example, interest rates on fixed-rate 30-year mortgages averaged 8.4 percent, while inflation (as measured by the broad-based gross national product deflator) was 5.4 percent. By 1978--the year in which deregulation of financial institutions began--the average mortgage interest rate had reached 9.6 percent, while the inflation rate had risen to 7.4 percent, resulting in a higher nominal mortgage interest rate but a lower

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19. In this survey, alternative mortgages are all fully amortized mortgages with variable rates or payment schedules (e.g., graduated payment, growing equity, and variable rate mortgages). Mortgages that modify other features of the instrument--such as reverse annuity mortgages or shared appreciation mortgages--are also included. Balloon payment mortgages and mortgages involving negative amortization (i.e., accrual of unpaid interest, which is paid off over time by adjusting the total loan amount) are not included. See Appendix C.

interest rate net of inflation. During the next three years, as the cost of funds to lending institutions climbed, nominal mortgage interest rates, as well as interest rates net of inflation, rose steeply. From 1979 through 1981, average mortgage interest rates increased from just under 11 percent to nearly 15 percent, while inflation, as measured by the GNP deflator, averaged about 9 percent. Since 1982, as inflation has abated, mortgage interest rates have also declined, although they remain very high in comparison to current inflation rates.

Although it is too early to assess the net effect of the deregulation of financial institutions on mortgage interest rates, there is reason to believe that as the housing credit sector becomes more fully integrated into the broader credit market mortgage interest rates will move more closely with other interest rates, reflecting the market-rate cost of funds to lenders. First, because deregulation will make depository institutions--the major source for mortgage loan originations--better able to compete for deposits during periods of high interest rates, the supply of mortgage funds may be less volatile in the future. Second, the increased reliance on the secondary mortgage market may contribute to a steadier supply of mortgage capital by increasing access to a greater number of sources of funds.

CHAPTER V. POLICY OPTIONS

The changes in the operation of the housing finance system described in the preceding chapter raise issues as to what the role of the federal government ought to be in the future. Are further measures necessary to increase the efficiency of mortgage markets? Should changes be made in the present system of federal housing subsidies either to make homeownership more affordable or to reallocate credit between housing and other sectors of the economy?

This chapter first examines proposals that have been made to increase the efficiency of mortgage markets, and then considers options for altering present subsidies for housing through changes in federal tax provisions. Several of the options considered here are included in legislation now pending before the Congress.

INCREASING MARKET EFFICIENCY

Proposals intended to increase the efficiency of the housing credit sector are of three quite different sorts, reflecting different views about the net impact of current federal housing credit programs.

One set of options would expand federal mortgage insurance or secondary market programs in certain subsectors of the housing market. These options are premised on the view that such programs promote the efficient operation of housing credit markets by reducing risks for mortgage lenders and by lowering transaction costs for secondary-market investors. An argument against them is that they may divert the flow of capital from other sectors of the economy. Also, in some instances federally sponsored activity may limit the development of private-sector alternatives.

Other proposals would change federal tax or regulatory policies to remove what are considered to be impediments to the development of greater private-sector secondary market activity. Specifically, these options are intended to facilitate the development and marketing of privately issued securities backed by mortgages that are neither insured nor guaranteed by the federal government. They would eliminate statutory or regulatory provisions that treat such securities on less advantageous terms than their nonhousing alternatives. Doing so could improve the efficiency of credit markets by eliminating provisions that decrease the relative return on housing investments. These options could be considered either as alternatives or supplements to the first set of options.

A third set of proposals would take a very different approach--reducing the role of federal credit entities, or diminishing their ties to the federal government, in the view that their operations impede the development of private alternatives. Proponents of these options contend that the availability of federally provided mortgage insurance and the activities of federally supported secondary-market credit entities limit private-sector alternatives. It is possible, however, that the risks associated with such activities would continue to constrain the development of private alternatives even if the federal government withdrew. Nor is it certain that private alternatives could generate efficiencies that would lower interest rates more than the federal programs. In any event, in contrast to the first two sets of options, proposals of this sort would carry substantial risks for the housing finance system if private institutions did not move in rapidly to assume the vacated federal role.

Although all of the options discussed here would alter the federal role in the housing finance system--and the first set would selectively increase federal activity--none of them would involve returning to the earlier policy of heavily regulating primary market mortgage lenders. In addition, while some actions might improve the efficiency of the housing finance system, housing would remain a highly cyclical sector of the economy since it is necessarily sensitive to interest rate fluctuations.

Expanding Direct Federal Housing Credit Activity

Options for selectively increasing federal activity in the mortgage credit market include:

- o Making additional alternative mortgage instruments eligible for federal insurance and guarantees; and

- o Expanding secondary markets in existing instruments.

These options, which would make incremental changes in existing programs, are intended to improve the efficiency of the mortgage credit market by absorbing some of the risk borne by lenders and by facilitating transactions in the secondary mortgage market. In several instances, these changes would adjust for the unintended consequences of federal policies and statutes that have failed to keep up with the development of new mortgage instruments. However, to the extent that private alternatives have already developed to fill these gaps, expanding the federal role could supplant private activity now under way.

Making Additional Alternative Mortgage Instruments Eligible for Federal Insurance and Guarantees. The federal government might make more types of alternative mortgage instruments eligible for FHA insurance and VA guarantees, and therefore eligible for inclusion in pools to back GNMA-guaranteed MBSs. Currently, the FHA and the VA may insure or guarantee only fixed-rate mortgages or instruments involving prescheduled payment adjustments, such as graduated payment mortgages and growing equity mortgages. Expanding FHA and VA programs to cover more types of mortgage instruments--such as adjustable rate mortgages, reverse annuity mortgages, and shared appreciation mortgages--could increase government-backed lending. 1/ On the other hand, this change could increase federal expenditures from insurance and guarantee funds if the different types of mortgages proved riskier and had higher default/foreclosure rates than those currently insured. While these expenses could be offset through higher premiums on the alternative instruments, data on the relative riskiness of adjustable rate mortgages that would be needed to set premiums are not available.

Expanding the Secondary Markets in Existing Instruments. The federal government might also expand secondary markets for existing mortgage instruments, such as loans on manufactured housing, cooperative housing loans, second mortgages, mortgages insured by state housing finance agencies, and mortgages on expensive dwellings. Secondary market trading of these instruments, although important for some submarkets, would probably yield only small increases in overall mortgage funds.

--Expanding the secondary market in manufactured housing loans. The Congress could amend the FHLMC Charter Act to authorize the purchase of loans on manufactured housing and their use to back MBSs. 2/ Although the existing secondary market for manufactured housing loans is small, manufactured homes provide an affordable alternative to site-built housing for low- and moderate-income households. Additional mortgage credit for

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1. S. 1338--reported by the Senate Committee on Banking, Housing and Urban Affairs on May 23, 1983, and amended by the Senate on June 21, 1983--would authorize FHA insurance for adjustable rate mortgages and shared appreciation mortgages, and, on a demonstration basis, for home equity conversion mortgages (one type of reverse annuity mortgage) for elderly homeowners. H.R. 1, as passed by the House of Representatives, would expand FHA authority to insure additional types of graduated payment mortgages.

2. These are loans secured in whole or in part by manufactured housing acquired as personal rather than commercial property.

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manufactured homes could assist these households in becoming homeowners. 3/ On the other hand, the fact that many manufactured housing units are financed through retail installment credit contracts, rather than by standard mortgage loan instruments, suggests that these loans may be riskier than mortgages on site-built homes. If so, the FHLMC could incur losses by developing a manufactured housing loan purchase program without establishing adequate standardization rules for these instruments. 4/

--Expanding the secondary market in cooperative housing loans. Federal legislation could expand the secondary market in cooperative housing share and blanket loans by taking steps to help standardize these highly variable instruments. 5/ Standardization could be promoted by specifying criteria--such as minimum loan amounts and project characteristics--for loans that would be favored for resale to the FNMA or the FHLMC. Because cooperative housing loans constitute a sizable proportion of all mortgage loans only in a limited number of markets--including New York City, Chicago, and Washington, D.C.--standardization of these localized loans might be a prerequisite if a national secondary market were to develop.

--Expanding the secondary market in second mortgages. The federal government could also facilitate the flow of funds to housing through the secondary market by authorizing the purchase of all types of second mortgage loans and mortgage participations by the FHLMC. Currently, although the FNMA has fairly broad authority to deal in second mortgages, the FHLMC is limited to making transactions only in second mortgage loans

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3. GNMA-guaranted securities backed by pools of manufactured home loans--primarily insured by the FHA under Title I of the National Housing Act of 1934, or guaranteed by the VA--currently sell well to institutional investors at yields close to the yields on GNMA-guaranteed securities backed by pools of single-family home loans.

4. H.R. 1, as passed by the House of Representatives, would authorize the FHLMC to purchase loans on manufactured homes. S. 1821, reported by the Senate Banking, Housing, and Urban Affairs Committee on October 6, 1983, would authorize the FHLMC to purchase loans on personal property manufactured homes.

5. Cooperative housing share loans are loans made to purchasers of individual cooperative units to finance a proportionate share of total project costs. A cooperative blanket loan is the single loan acquired either to build a cooperative project or to convert a project to cooperative units.

for energy and home improvement purposes. 6/ Broadening the authority of the FHLMC in this area would provide another source for the purchase of such loans and for the issuance of MBSs backed by them. This could be especially important because the increased use of seller financing and other "creative" financing techniques in recent years has greatly increased the volume of second mortgage loans made--reaching an estimated $17 billion to $19 billion in 1982 alone. 7/

While this change could augment the amount of housing credit available through the federally sponsored credit agencies, it would involve some risk. Specifically, because of noncomparability among second mortgages and between second mortgages and first mortgages, the process of pooling them could pose problems, and the liability exposure of issuers could make the price unacceptable to investors. A system might therefore be needed to provide more complete information on the risks associated with second mortgages. Although potentially costly and time-consuming to develop, such information could protect the federally sponsored credit agencies and the investors in second mortgage loans.

--Expanding the secondary market in loans insured by state housing finance agencies. The Congress could amend the FHLMC Charter Act to authorize the purchase of conventional mortgages insured by state housing finance agencies. 8/ Such a change could provide secondary market support for the state agency mortgage insurance programs which, in some instances, provide coverage for low- and moderate-income homebuyers unable to

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6. H.R. 1, as passed by the House of Representatives, would expand the authority of the FHLMC to include transactions in all types of second mortgage loans on one- to four-unit homes and would state explicitly the authority of the FNMA to deal in conventional second mortgage loans--without the HUD regulations required for new programs. S. 1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would put the FNMA and the FHLMC on equal footing by authorizing both corporations to purchase second mortgages for home purchase or improvement.

7. Advance Mortgage Corporation, U.S. Housing Markets, October 22, 1982.

8. H.R. 1, as passed by the House of Representatives, would authorize the FHLMC to purchase state agency-insured mortgage loans. S. 1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would include state agency-insured mortgage loans among those conventional loans eligible for purchase by the FHLMC.

obtain private mortgage insurance. On the other hand, only five state agencies have mortgage insurance programs, and one of these agencies (in California) has yet to issue any insurance. 9/ Because the volume of mortgages insured by the other state agencies would probably be small, such a purchase program, though potentially significant in those states, would likely have little impact on the overall market for housing credit.

--Increasing the maximum size of loans eligible for FNMA and FHLMC purchase programs. The Congress could increase the number of loans eligible for FNMA and FHLMC purchase programs by amending the charter acts of these organizations to raise the current $108,300 ceiling on the value of individual mortgage loans purchased. 10/ Specific options include: raising the ceiling to a new absolute-dollar level, lifting the ceiling only in high-cost areas, allowing the FNMA and the FHLMC to purchase a certain percentage of mortgages valued above the current ceiling, or eliminating the ceiling entirely.

The effects of increasing the maximum loan size in FNMA and FHLMC purchase programs would vary according to the means chosen and the costliness of housing in a given market area. Raising the ceiling to a new absolute-dollar amount would expand access to FNMA and FHLMC programs in all areas with sizable shares of their housing stock selling for well above the present limits but would still leave access limited in the highest-cost markets. Lifting the ceiling only in high-cost areas would leave the top end of the market less well served in other areas but would result in a more equitable treatment across markets. Allowing the FNMA and the FHLMC to make a certain percentage of their mortgage purchases above the present limits would give those credit agencies discretion in determining what areas to serve, with the impacts less predictable.

On the other hand, any increase in the present ceiling would place the FNMA and the FHLMC in competition with private-sector credit entities such as the Residential Funding Corporation (RFC), recently established to provide a secondary market for large mortgage loans. 11/ Eliminating the

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9. The other housing finance agencies with mortgage insurance programs are in Maryland, Vermont, New York, and Puerto Rico.

10. H.R. 3420, introduced in the House of Representatives on June 27, 1983, would raise the maximum purchase price limitations in high-cost areas for the FHLMC and the FNMA purchase programs to equal those established for the FHA Section 203(b) mortgage insurance program.

11. The RFC, a subsidiary of Norwest Mortgage, Inc., sells mortgages underwritten by the Mortgage Guaranty Insurance Corporation (MGIC)

ceiling might result in the FNMA and the FHLMC completely displacing the private-sector credit entities from the secondary market for large mortgage loans because of the relative advantage the federally sponsored credit agencies would have in their scale of operation and in the favored market status of their securities.

Encouraging Housing Credit Activity by the Private Sector

A second set of options would alter federal tax or regulatory policies to encourage the development and marketing of privately issued conventional mortgage-backed securities--that is, securities backed by mortgages neither insured by the FHA, nor guaranteed by the VA or the FmHA. Active trading in such securities could expand substantially the sources of funds for mortgage loans, if pension plans and other investors (such as life insurance companies and real estate investment trusts) became major purchasers of these instruments using funds they would not otherwise have invested in housing. Such privately issued securities have been slow to develop, however. Since 1977, when the first major private, conventional MBSs were issued by the Bank of America and by the First Federal Savings and Loan Association of Chicago, fewer than 50 private institutions have issued mortgage-backed securities. As of June 1982, available data on both publicly and privately placed issues indicate that only $4.4 billion in privately issued conventional MBSs were outstanding. 12/

Many factors have been cited as impediments to the development of an active secondary market in privately issued conventional MBSs, including regulations of the Federal Reserve System, the Securities and Exchange Commission, the Department of Labor, and the Internal Revenue Service, all of which have been criticized as adding to the costs of potential issuers of private MBSs. These regulations are often historical accidents of policy

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11. (Continued)
    to investors through the Salomon Brothers Co. The types of mortgage loans purchased by the RFC include: 15-year loans valued up to $500,000; wraparound mortgages; growing equity mortgages; graduated payment mortgages with buydowns; adjustable rate mortgages, including those with investor borrowers; and 30-year fixed rate mortgages with down payments of at least 5 percent.

12. Lepercq, de Neuflize and Co., Summary of Mortgage-Backed Securities Issued (Outstanding as of June 30, 1982).

that reflect the fact that private MBSs did not exist when the regulations were first established. Therefore MBSs are not covered by them in a systematic way. 13/

Although several of the perceived impediments to active trading in such instruments have been removed recently, others remain. 14/ Options for reducing remaining barriers to the development of an active market in privately issued conventional MBSs include:

- Standardizing privately issued conventional MBSs and improving information regarding the riskiness of individual issues;

- Amending the federal tax code to remove disadvantages now borne by privately issued conventional MBSs; and

- Further modifying ERISA regulations to encourage pension fund investment in these securities. 15/

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13. See The Report of the President's Commission on Housing (1982), p. 145, for further discussion of these policy accidents.

14. The Federal Reserve System now allows privately issued conventional mortgage-backed securities with certain characteristics to be traded over-the-counter (i.e., without registration) using margin loans at brokerage firms. Regulation T previously provided this privilege only to corporate obligations. Its extension to cover conventional privately issued MBSs requires: an original issue of $25 million, current filings with the Securities and Exchange Commission, and the passing through of mortgage interest and principal payments by the agent according to the terms of the offering. In addition, the Securities and Exchange Commission has eliminated the 30- to 60-day filing delay often encountered in registering and therefore marketing all securities. Recent rulings by the Department of Labor on eligible investments for pension plans covered by the Employee Retirement Income Security Act (ERISA) regulations have also removed some barriers to investment in privately issued conventional MBSs. See 47 FR 43070, 47 FR 55912, and 47 FR 39799.

15. S. 1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would take several other actions to remove impediments to active trading in privately issued MBSs by: broadening the exemption from security registration requirements; preempting state registration and investment requirements; and extending SEC shelf

Even if all these actions were taken, however, it is unclear whether or how quickly a secondary market in privately issued conventional MBSs would supplant the existing federally supported one. For one thing, concerns about the safety of the underlying mortgages or the possibility of prepayment may continue to make these securities less attractive than nonhousing securities. 16/ Also, as long as federally supported MBSs exist, investors may continue to view privately issued conventional securities as less desirable investments because they are not issued by an entity with ties to the federal government. If the interest-rate differential required to attract investors to the riskier instruments could not be supported by the rates paid on the underlying mortgages, the private market would not expand.

Standardizing Privately Issued Conventional MBSs and Improving Information Regarding their Riskiness. Some view the lack of uniformity in the underlying conventional mortgages and the lack of information about their quality to be impediments to the development of a market for privately issued conventional MBSs.

The federal government could help standardize these securities through regulations by the FHLBB or the Comptroller of the Currency establishing criteria--such as limits on the loan-to-value ratio, the maximum dollar value, and the age and form of the underlying mortgages--for mortgages placed in pools to back these MBSs. Standardization could also include a requirement that a reserve fund be maintained to help ensure timely payments on the security, if cash flow from the pool proves insufficient. 17/ Requiring a reserve fund could increase investor confidence that principal and interest payments would be made but could also lessen the net return to investors. The size of such a reserve and the rate of

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15. (Continued)
registration (i.e., an abbreviated and time-saving registration process that can be used when disclosure materials remain unchanged for several MBS issues) beyond its 1983 expiration.

16. All types of MBSs have a different term structure from--and are marketed at a disadvantage to--nonhousing securities, because of the scheduled amortization payments on their underlying investment and the possibility of prepayment of the individual mortgages in a pool.

17. See The Report of the President's Commission on Housing (1982), p. 148. Depending on the use intended for privately issued conventional MBSs, the requirement of a reserve fund could necessitate the issuance of regulations by the FHLBB, the Department of Labor, or the Securities and Exchange Commission.

return realized on it would be crucial to the profitability and, hence, the competitiveness of these instruments. In addition, too much standardization could limit innovation in the forms of mortgages that might otherwise occur in times of high interest rates and inflation.

Information on MBSs could be improved by establishing a service to rate securities according to the riskiness of the underlying mortgages and the issuer's past performance. Because such a rating service would increase the available information about the quality of privately issued conventional MBSs, it could increase investments in these securities. On the other hand, establishing and operating a rating service would not be without cost. If the costs of such a service was borne by the federal government, it would add to the budget deficit. If, instead, the service was funded out of fees paid by issuers or buyers of the securities, the expense would lessen the net yield on the MBSs but could also reduce their riskiness.

Amending the Federal Tax Code. The federal tax code may also constrain the development of a secondary market in privately issued MBSs by taxing these securities' proceeds at both the certificate holder and asset pool levels. Although income from regulated investment companies (e.g., mutual funds) which issue the securities most competitive with MBSs is taxed only at the shareholder level, issuers of actively managed MBSs can be taxed at the pool level, even if all net income is passed through to the certificate holders. To avoid double taxation, most MBS portfolios are managed passively through the inflexible grantor trust device. This device restricts the substitution of loans, the reinvestment of principal payments, the use of investment contracts to insure anticipated yields, and the use of delayed delivery mortgages. These restrictions reduce profitability and, if removed, could provide greater certainty of cash flow and protection for the investor from the call of a mortgage upon prepayment and thus the loss of its value from the security.

Making privately issued conventional MBSs eligible for the same tax treatment as securities issued by regulated investment companies could increase the profitability of the instrument and, thus, the number of such instruments issued. On the other hand, making MBSs eligible for taxation only at the shareholder level without the constraints of the grantor trust management mechanism would increase trading in privately issued conventional MBSs only if investment brokers and managers became convinced that MBSs issued under the more favorable tax code would be as marketable as other securities. Also, to the extent that such a change increased the overall flow of capital to housing, it would divert investments into a sector of the economy that already enjoys many advantages through the federal tax system, unless these are modified.